A Guide to the Due Diligence Process
What is due diligence?

‘Due diligence’ is an investigation into the affairs of a company prior to its acquisition, disposal, refinancing, restructure, public listing or other similar transaction.

The aim of due diligence is to enhance a user’s understanding of key information underpinning a corporate transaction, allowing parties to make informed investment decisions.

There are no hard and fast rules of what the due diligence process involves, and each engagement will be individual to the specific transaction. Due diligence is a bridge that must be crossed in nearly all transactions, without it, the risk of problems or failure along the journey are increased.
What does the due diligence process cover?

The scope of a due diligence engagement depends on the user’s view of their needs, the nature of the transaction and the perceived risk associated with the target entity.

Due diligence typically falls in to the following broad categories:

**Financial due diligence**
A review of historic data (trading results, balance sheet and cash flows) for the entire entity or possibly on specific projects, review of forecast performance and funding requirements. Assessment of the impact, if any, on the value of the target business, and any tax issues arising.

**Commercial due diligence**
Could encompass a review of various commercial factors including but not limited to; market conditions, sector specific legislation, competitor analysis, product or service assessment or any other commercial aspects the user wishes to investigate.

**Operational due diligence**
Consideration of non-financial matters of a target business, which may include assessment of systems and processes, review of the incumbent management team, staffing levels and other HR activities, or insurance arrangements and risk assessment.

**Legal due diligence**
Investigation of any legal risk associated with the rights and obligations of the target entity. Issues may typically involve property ownership, intellectual property and employment disputes.
What does the due diligence process cover?

Environmental due diligence
Typically concerns compliance issues with environmental legislation, but recent trends for ethical and responsible business dealings have lead to a sharper focus on ‘green’ issues.

It should be noted that there are no clear boundaries between these categories. One or more of the above areas may not be relevant to all due diligence engagements, and a bespoke scope will be required to focus on the particular issues of each unique transaction.
Why undertake due diligence on an acquisition?

Due diligence is accepted practice amongst acquirers and provides a key aspect of risk mitigation in the purchase process. Ensuring you have every piece of the puzzle prior to completion will help avoid and nasty shocks post acquisition.

Typical outputs of a due diligence engagement may include:

- Information which may have bearing on the final investment decision
- Information upon which transaction terms may be based
- Information that could be used to negotiate price
- Factors which may aid tax and financing structure
- Warnings for which protection in the form of warranties or indemnities may be required
When to commission sell-side due diligence?

The due diligence process can often be seen as onerous and time consuming for management at the target entity. Similar to statutory audits, advisors conducting due diligence assignments will expect access to key financial records and may also have questions regarding commercial aspects, systems and operation of the business.

The key to a successful transaction is planning and communication. An agreed timetable with the acquirer's advisers will help to ensure a smooth process. Timely provision of information and a willingness to engage in a constructive dialogue with the investigating professionals, can help alleviate confrontation and prevent negotiations from becoming hostile.

Over time, the due diligence product has evolved with a growing trend for business owners to commission vendor-driven due diligence, on the business they are trying to dispose of.

The vendor rather than the acquirer commission due diligence, with the resultant report made available to potential acquirers. The report is prepared with the purchaser's interests in mind, but is made without establishing a duty of care in the early stage.

The advantages of vendor driven due diligence are that the process becomes less of a distraction for management, gives more control of investigations to the vendor, and provides a common understanding of the key issues for all parties involved.
Planning effective due diligence

Tailoring the scope of due diligence assignments

The first step of any due diligence assignment should be to discuss the scope of the engagement in order to:

- Understand the proposed transaction and the degree of access expected
- Understand what benefits are expected to arise from the due diligence process
- Identify client concerns and implement strategy to counter these
- Understand the scope of work for the advisor and potentially what areas the client expects to cover themselves
- Determine the overall timetable for the process and delivery of the due diligence report

Once agreed, the scope of the engagement will allow advisors to deliver a report containing information pertinent to the purchaser, which will act as a meaningful decision making tool throughout the transaction.
Dealing with the findings of due diligence?

In an acquisition, once the findings of due diligence have been reported, their impact on the overall deal can be discussed and the acquirer can form a clear view of the options to manage any issues.

Broadly speaking there are three approaches to address the identified issues.

**Price Reduction**
If your initial bid was not borne out of due diligence it may be appropriate to revisit your offer. If this is the case, be sure to document the reasons for the change of position since your initial expression of interest, linking it back to evidence, for instance, loss of key customer contracts.

**Legal Protection**
This should be used in instances of uncertainty or as a requirement for risk mitigation. Use of escrow accounts, indemnities and warranties are all common outcomes of the due diligence process. Typically these will be included in any Share Purchase Agreement, with the vendor providing representations at the point of purchase. Should such provisions be refused by the vendor, then an acquirer may have to be prepared to walk away from the deal.

**Post-deal**
Some issues such as deficiencies in basic reporting cannot always be addressed pre-deal, despite the risk they may present to the acquirer.

These can be dealt with using a post-deal plan whereby vendor and acquirer work together post acquisition to validate pre-deal assumptions, develop integration strategies and commence the delivery of short term goals.
Getting the right due diligence team

For an effective and efficient due diligence assignment it is important to engage a team with the relevant skills.

Key skills forming the foundation of expert team:

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<th>The Right Due Diligence Team</th>
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<td><strong>Stamina</strong></td>
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<td>energy, and determination to resolve issues and work to timetables and deadlines</td>
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<tr>
<td><strong>Identify Key Drivers</strong></td>
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<td>to ensure a focussed approach, be alert to problem areas and inconsistencies</td>
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<td><strong>Commercial Awareness</strong></td>
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<td>combined with practical experience and a questioning mind</td>
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<td><strong>Communication</strong></td>
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<td>Personal skills and an ability to communicate clearly, and without ambiguity</td>
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<td><strong>Relevant Expertise</strong></td>
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<td>to provide targeted and useful due diligence feedback that adds value.</td>
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At Bishop Fleming Corporate Finance we can draw from a vastly experienced team, who have undertaken assignments across a wide range of sectors. We pride ourselves on building the right team for each transaction in order to deliver a tailored product for each of our clients.
How Bishop Fleming Corporate Finance can help

Whether you have identified a target business or are just at the outset of a potential acquisition opportunity, Bishop Fleming Corporate Finance can provide valuable assistance to help drive the transaction process.

We can undertake due diligence assignments for company acquisitions, mergers and not for profit transactions. We can also assist in the preparation of vendor-driven due diligence to aid the sale process.

Having undertaken due diligence engagements across a number of sectors, our corporate finance team, assisted by the firm’s numerous other technical specialists, can improve your chances of achieving the right deal and a successful outcome.

No obligation initial meeting
If you believe that you have identified a potential buy-out opportunity and would like to explore the possibility further we would be happy to arrange a no obligation meeting with you.

Contacts
For more information or to arrange for an initial exploratory meeting please contact a member of the Corporate Finance Team at your nearest office:

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